Profile of the Economy

[Source: Office of Economic Policy, Office of Financial Analysis]

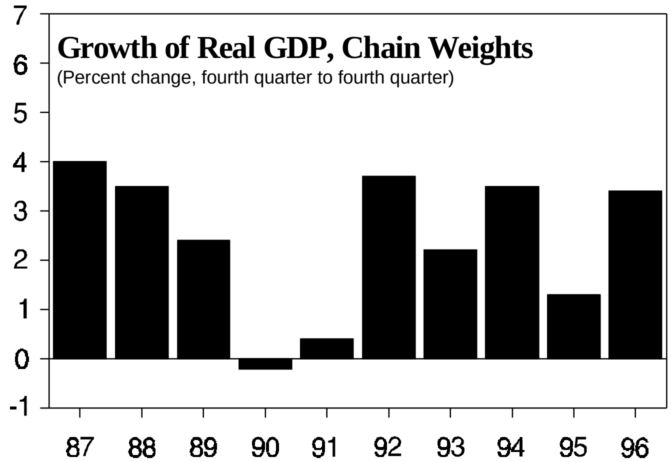
Real gross domestic product

Economic growth was very strong in 1996 with real gross domestic product (GDP) rising by 3.4 percent during the four quarters of the year. This rate was an improvement over the 1.3 percent in 1995 and in line with the 3.5 percent growth in 1994. [On an annual average basis, real GDP rose by 2.5 percent in 1996.]

Growth over the year was boosted by a 4.7 percent annual rate of gain in the final quarter, well above the 2.1 percent pace in the third quarter. In the fourth quarter, growth in the foreign trade sector improved dramatically, and consumer spending rebounded to a 3.4 percent annual rate from an increase of just 0.5 percent in the third quarter.

Private nonresidential investment continued to grow rapidly in 1996, as it has throughout the expansion. Equipment investment increased 9.4 percent, although growth eased in the final quarter of the year following a very rapid surge in the third quarter. Investment in structures accelerated to 8.4 percent in 1996, its fastest pace in 12 years.

Inflation was very low in the fourth quarter and throughout 1996 despite the pick-up in economic growth. The chain-weighted price index for GDP moderated to a 1.8 percent annual rate of gain in the fourth quarter from 2.0 percent in the third. Over the entire year the index grew just 2.1 percent, the lowest since 1965. Prices paid by U.S. residents, excluding exports and including inports, also posted the smallest rise since 1965.



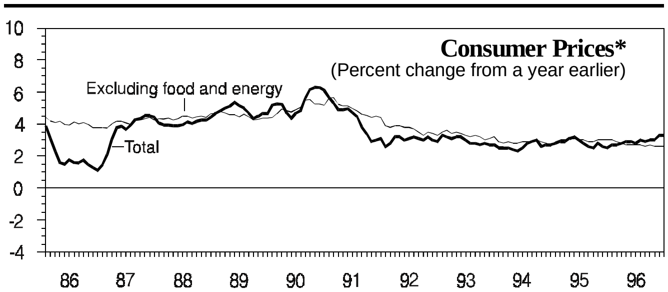
Consumer and producer prices

Inflation was extremely favorable in 1996, aside from a pickup in food and energy prices. "Core" inflation, excluding the volatile food and energy components, showed signs of continued deceleration.

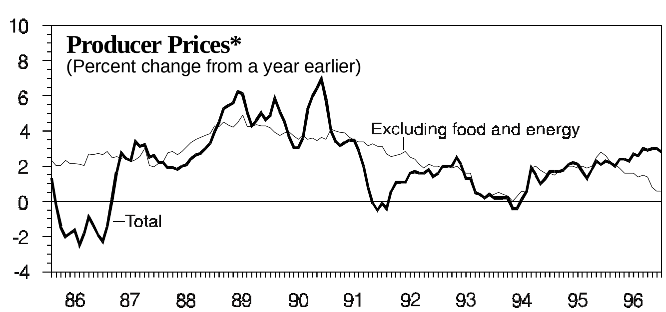
The consumer price index (CPI) rose by 3.3 percent last year, up from an increase of 2.5 percent during 1995. Food and energy prices were responsible for all of the acceleration. The core CPI advanced only 2.6 percent last year, down from 3.0 percent during 1995 and matching the low 1994 increase which was the smallest since 1965.

The producer price index (PPI) for finished goods increased by 2.8 percent during 1996, up from 2.3 percent the previous year as food and energy boosted results. On a core basis, finished goods prices edged up by a mere 0.6 percent, very close to the 0.4 percent during 1993, the series low. At earlier stages of processing, core prices declined during 1996.

The cost of compensating labor, which typically rises when labor markets are tight, accelerated only a little last year. The employment cost index rose by 2.9 percent during 1996, little different from the 2.7 percent increase of 1995. A slight speedup in the growth of wages and salaries was partially offset by a further slowdown in benefit costs.



*Year tick marks correspond with June data.



Real disposable personal income and consumer spending

Real disposable (after-tax) personal income rose at a 2.5 percent annual rate in the fourth quarter and by 2.7 percent over the entire year, a little less than the 3.1 percent increase over all of 1995. The composition of growth in 1996 was nonetheless favorable, as real wage and salary income increased faster than in the previous year. A smaller rise in interest income, along with higher tax payments reflecting in part the last installment of the 1993 tax hike on upper-bracket incomes, accounted for most of the slowdown in total after-tax income.

Real consumer spending picked up in 1996, rising by 2.7 percent over the four quarters compared with 1.9 percent over all of 1995. Spending rose at a 3.5 percent annual rate during the first half of the year, slowed abruptly to only 0.5 percent in the third quarter, then rebounded to a 3.4 percent annual rate in the final quarter of the year.

The share of after-tax income devoted to personal saving rose to 5.2 percent in the second half of last year from 4.6 percent in the first half. For the year as a whole, the personal saving rate averaged 4.9 percent, up slightly from 4.7 percent in 1995 and a low 3.8 percent in 1994.

Industrial production and capacity utilization

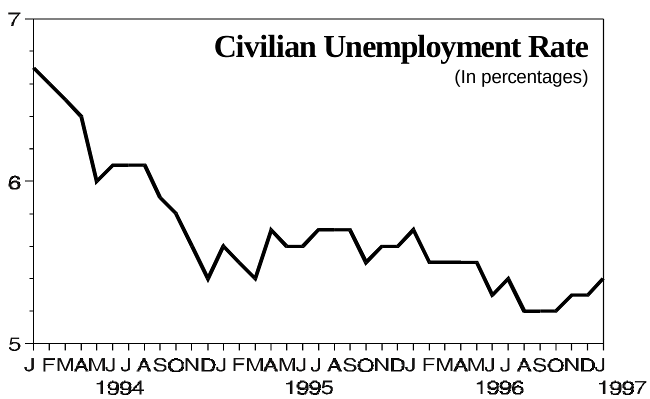
Industrial production in manufacturing, mining, and utilities grew strongly by 4.3 percent during 1996. This was substantially above the growth of 1.1 percent registered during 1995.

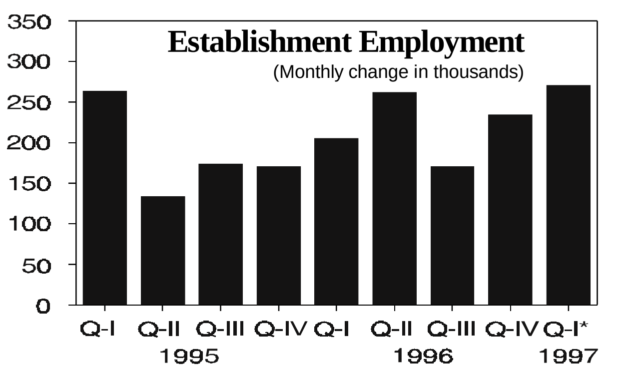
Manufacturing production grew at a healthy rate of 4.8 percent during the last year. Within manufacturing, the production of computer equipment showed big advances; however, production of motor vehicles and parts on balance declined during the year. At the end of the year, weather affected the output of utilities. It weakened because the mild December weather reduced heating requirements.

The industrial capacity utilization rate closed 1996 at 83.5 percent. This was up from 83.0 percent a year earlier, but still 1.4 percentage points below the peak rate for the current business cycle expansion of 84.9 percent. The long-term average for the years 1967 through 1995 was 82.0 percent.

Employment and unemployment

Increases in jobs on nonfarm establishment payrolls accelerated to an average of 218,000 per month during 1996 from 185,000 per month during 1995, for a total of 2.6 million new jobs in 1996. In January of this year, employment rose by 271,000.





*Based on data for January.

Strength over the past several years has been centered in the private service-producing sector of the economy, which has added 2.4 million jobs since December 1995. Manufacturing employment, which had fallen by 319,000 from its peak in March 1995 through last September, rose by 53,000 jobs from September through January 1997. Federal Government employment has been on a long-term decline: nonpostal Federal employment has fallen by 320,000 since its May 1992 peak, and the level in January was the lowest since May 1996.

The unemployment rate in January was 5.4 percent. Unemployment has been in the narrow band between 5.2 to 5.7 percent of the labor force since October 1994, and has fallen 2.4 percentage points below the June 1992 peak of 7.8 percent. The share of the total working-age population that is employed rose to a new high of 63.6 percent in January.

Nonfarm productivity and unit labor costs

Nonfarm business productivity, or real output per hour worked, rose strongly by a 2.2 percent annual rate in the fourth quarter of 1996. Growth was 1.2 percent over all of 1996, near the long-term trend growth rate of 1.1 percent. That was a marked improvement over the last 3 years, when on balance there was no growth.

Hourly compensation costs in the nonfarm business sector rose by a 3.6 percent annual rate in the fourth quarter and during the entire year. Labor costs per unit of output, which combine the impact of growth of compensation and productivity, are a key indicator of potential inflation. The rate rose at a slow 1.4 percent annual rate in the fourth quarter and by 2.4 percent during all of 1996. Such a low rate of advance indicates little inflationary pressure.

Productivity in manufacturing, included in the nonfarm business sector, remains strong. It grew by 4.0 percent during 1996. Unit labor costs in manufacturing fell by 0.6 percent during 1996.

Current account balance

The current account is the broadest measure of U.S. transactions with the rest of the world, covering not only trade in goods and services but income flows as well. The deficit grew from a recent low of $10 billion in 1991 to a high of $148 billion in both 1994 and 1995. The widening reflected the faster pace of U.S. economic growth, which brought in imports at a more rapid rate than exports.

Through the first three quarters of 1996, the current account deficit widened even further, averaging $164 billion at an annual rate. This still represented just 2.2 percent of GDP, however, little changed from the preceding 2 years.

The widening deficit in 1996 reflected deterioration in the balance on goods and on investment income. In contrast, the surplus in services trade improved. Growth in the investment income deficit was mainly due to rising interest payments on the rapidly growing foreign holdings of U.S. Treasury securities.

In the fourth quarter, the deficit balance on goods narrowed dramatically and the services surplus increased even further. This suggested an improvement in the current account deficit for the final quarter of the year.

Exchange rate of the dollar

The appreciation of the dollar began in the middle of 1995 and continued through 1996. So far in 1997 it has accelerated. Based on the Federal Reserve Board's trade-weighted index of the dollar against G-10 currencies, the dollar had risen by 8.4 percent by the end of 1996 from the all-time low reached in April 1995. In January, the dollar rose by a further 2.6 percent.

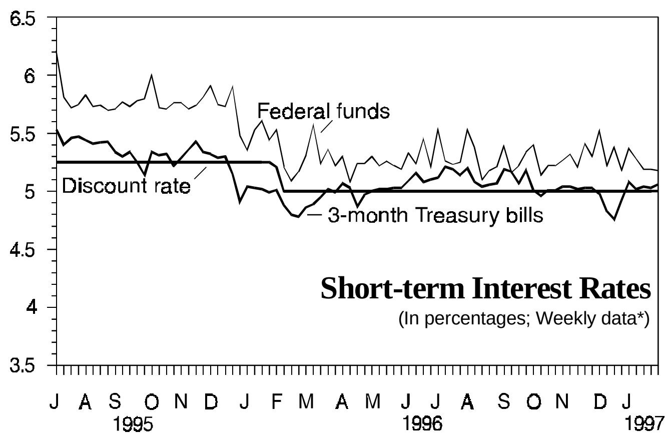
Most of the dollar deterioration that had occurred in 1994 was against the yen and the deutschemark, and the improvement was also greatest against these currencies. Between April 1995 and January 1997, the dollar rose by more than 40 percent against the yen and by more than 16 percent against the deutschemark.

Despite the improvement, the trade-weighted index of the dollar remains about 6 percent below its recent high of January 1994. Many factors determine the level of exchange rates in international currency markets. Underlying economic fundamentals in the United States are sound and confidence in the dollar is high.

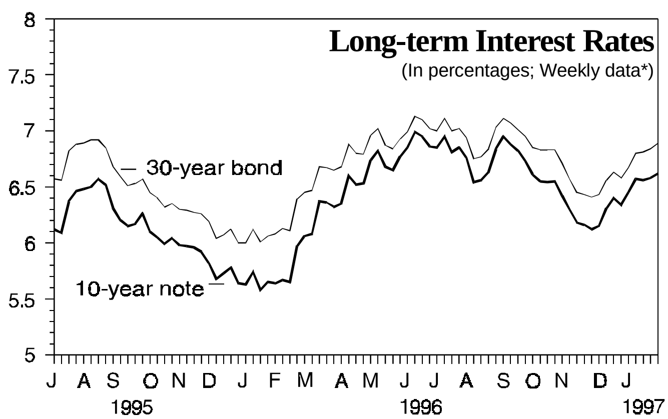
Interest rates

Since early last year, the Federal Reserve Board has held the Federal funds rate target constant at 5.25 percent. The unchanging target has been consistent with an economic situation of continuing growth and little inflationary pressure. Short-term interest rates have similarly remained stable since then, with the 3-month Treasury bill rate staying near 5.0 percent.

Long-term interest rates moved higher in the early part of 1996 and then eased. Since late last year, long-term rates



*Average for week ending Friday; Federal funds ending Wednesday.



have turned up a bit. The yield on the 30-year Treasury bond is currently around 6.8 percent, up from about 6.45 percent around last November.

Mortgage interest rates have been very favorable. Early in 1996, the rate for a 30-year fixed rate loan was about 7 percent, close to the 25-year lows reached in October 1993. This rate rose within the year and then fell to less than 7.75 percent by the end of the year, low by historical standards. In early 1997, the rate increased to around 7.8 percent.

Net national saving and investment

During the first three quarters of 1996, net national saving, which excludes depreciation to replace worn-out or obsolete equipment and structures used in production, rose to 6.1 percent of net national product (NNP). That rate was up from 5.1 percent in 1995 and as low as 2.7 percent in 1992. Despite the gains, net saving remains only half as high as the 12 percent of NNP averaged in the 1960's.

Recent improvement is mainly the result of the narrowing of the Federal deficit. That has reduced Government dissaving to 1.5 percent of NNP through the first three quarters of 1996 from 4.8 percent in 1992. Private saving, of households and businesses, was equivalent to 7.5 percent of NNP through the first three quarters of 1996, up a little from a historic low of 6.4 percent in 1994. Even so, private saving is still well below the nearly 10 percent of NNP averaged in the 1960's and 1970's.

Net domestic investment equaled 7.3 percent of NNP over the first three quarters of 1996, up from a low of 4.1 percent in 1991. Foreign inflows were equivalent to 2.2 percent of NNP, or about one-third of domestic investment. U.S. sources provided investment equivalent to 5.1 percent of NNP, less than half the share of NNP averaged in the 1960's and 1970's.

Housing

Housing activity was very strong in 1996. Although bad weather held down most indicators of the housing market in December, the year as a whole was one of the best for housing in many years.

Starts of new homes totaled 1.47 million in 1996, the best year for home building since 1988. Single-family starts increased nearly 8.0 percent over the 1995 level to 1.16 million units. Starts of new multi-family units improved by almost 13 percent in 1996 to 314,000 units.

Home sales also reached new expansion peaks in 1996, contributing to the rapid growth in new starts. Sales of new single-family homes reached 756,000 in 1996, up from 667,000 in 1995 and the highest in 18 years. Sales of existing homes topped the 4 million mark for the first time since that series began in 1968. The homeownership rate rose to 65.6 percent in the third quarter, the highest in 15 years, before easing back slightly in the fourth quarter.

Rapid growth in employment and income and very favorable readings of consumer confidence fueled the expansion in the housing market in 1996. Rising mortgage interest rates during the middle of the year were somewhat offset by a shift on the part of home buyers to lower-cost adjustable rate mortgages. Over the final 3 months of the year, fixed mortgage rates came down to below 8.0 percent for a 30-year loan, a very favorable rate by historical standards.

Federal budget deficit

The Federal budget deficit fell to $107.3 billion in fiscal 1996, the lowest in 15 years and about $57 billion below the level of the previous fiscal year. As a share of GDP, the deficit was 1.4 percent, the smallest share since 1974.

The deficit has been shrinking since fiscal 1992, when it reached an all-time high of $290 billion. Since then, the deficit has been cut by almost two-thirds, or a total of $183 billion. Strong economic growth and passage of the Omnibus Budget Reconciliation Act of 1993 set the deficit on its downward course.

Further deficit reduction is expected over the next 6 years, with the Administration's "Fiscal Year 1998 Budget" projecting balance by 2002. The deficit is projected to increase slightly in the current fiscal year as economic growth is expected to return to its long-term growth path, but then the deficit falls again in each of the next 5 years, showing a small surplus by fiscal 2002. Receipts are forecast to grow an average of 4.5 percent a year between fiscal 1996 and fiscal 2002, while growth in outlays is projected to be held to 3.2 percent a year. ◊